EC 1222 • Reprinted April 1998
$1.50

Managing a New Business

A Beginner's Guide to Financial Concepts and Tools

OREGON STATE UNIVERSITY EXTENSION SERVICE

Successful small business management frequently depends on the manager's knowledge in five key areas: profit planning, using financial statements, analyzing cash flow, maintaining a healthy financial structure, and the ability to control and plan for future capital needs.

If you have a good working knowledge in these areas, the financial aspects of your business should be successful. This publication briefly describes and illustrates these areas. They are important considerations, regardless of whether you are just thinking about starting a business or are a longtime business operator.

Planning for profit

Profit planning is a continuing process. It does not guarantee a profit, but profits are more likely to materialize when you plan for them. Profit planning usually does not account for such things as natural disasters or government intervention.

You should consider the following steps when planning for profit.

Analysis

First, you must analyze the existing operation of your business. This analysis will help to determine its strengths and weaknesses. You might discontinue unprofitable parts of your business.

It is frequently helpful if you can compare this analysis with those from businesses similar to yours. Doing this helps sometimes to show the strengths and weaknesses of your business.

Key performance areas (KPA's)

The next step is to determine these major elements of your business that influence profits, such as sales (receipts), expenses, and margins. Make a realistic projection for each KPA.

If, for example, you expect sales to be down during the planning period because of such things as lower prices or production, don't make the projected sales *high*—this would be self-defeating. Be sure your KPA projections are realistic, measurable, and in writing.

Action plans

Next, make *flexible* action plans to achieve the KPA projections. Action plans are step-by-step procedures that spell out how you will achieve your projections within the specified time periods. These action plans should be flexible so that you can make adjustments for unexpected events.

Putting them to work

After you've made your action plans, try them out! You can evaluate the success of the action plans by comparing actual results with the planned KPA results.

Adjusting your plans

The next step in the profit-planning process is to make changes in your action plans as needed to achieve the KPA projections/objectives you previously established. In some cases, you may have to go back to the beginning of the profit-planning process and start all over again. You would probably want to do this if you made grossly unrealistic projections or if there were unexpected disasters.

Using financial statements

To analyze the financial position of your business, there are three fundamental financial statements you should prepare and use: a balance sheet, a profit and loss statement, and a sources and uses of funds statement.

Balance sheet

The balance sheet also is called a *financial statement, net worth statement,* or *statement of financial condition.* Its purpose is, in part, to provide basic data for analysis of the liquidity, solvency, and net worth of your business at a specific moment in time. It tells you "where your business is" at that moment.

The balance sheet is a systematic listing of all the assets, all the liabilities, and the net worth of your business. Assets are what your business owns, liabilities are what the business owes, and net worth is your investment (equity) in the business. Prepare it on a regular basis (monthly, quarterly, or annually).

An example of a simple balance sheet is shown in Illustration 1. It lists the assets, liabilities, and equity for My Business as of a specific date, January 1, 19xx. Both the assets and liabilities are broken into current and long term categories.

Assets. *Current assets* are those that you expect to last 1 year or less; they're typically listed in order of their cashlike quality. So cash itself is listed first. Accounts receivable are amounts owed to you. Total current assets in this example are $23,193.

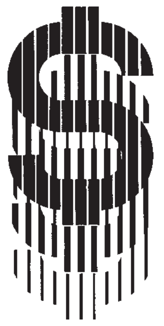

Illustration 1

My Business
Balance sheet
January 1, 19xx

Assets			
Current			
Cash		$ 2,748	
Securities		2,345	
Accounts receivable		2,000	
Inventories			
Merchandise		12,600	
Supplies		3,500	
Total current assets			$23,193
Long term			
Equipment (at cost)	$ 7,000		
Less accumulated depreciation	– 1,015		
Equipment (net depreciated value)		5,985	
Buildings (at cost)	40,000		
Less accumulated depreciation	– 9,800		
Buildings (net depreciation value)		30,200	
Land (at cost)		1,800	
Total long term assets			37,985
Total assets			$61,178
Liabilities			
Current			
Accounts payable	$ 1,000		
Annual mortgage principal due (bank notes payable)	5,800		
Accrued expenses payable	800		
Total current liabilities		7,600	
Long term			
Mortgage (less current portion)		25,000	
Total liabilities			$32,600
Owner’s equity			28,578
Total liabilities and equity			$61,178

The *long term assets* in Illustration 1 consist of equipment, buildings, and land. They are asset categories that you expect to last more than 1 year. All are valued at cost. Accumulated depreciation (the sum of depreciation taken on an asset over its lifetime) is shown as a deduction from the value of all equipment and buildings that are depreciable.

From an accounting viewpoint, land is not a depreciable asset since it is not expected to wear out as other assets do. Total long term assets for My Business are $37,985 (net depreciated value). Total assets, the sum of current and long term assets, are valued at $61,178.

Liabilities in Illustration 1 also are divided into current and long term portions. As in the asset categories, *current liabilities* are those that you expect to pay within 1 year or less. In Illustration 1, total current liabilities are $7,600.

They consist of accounts payable, annual mortgage principal due, and accrued expenses payable. Accounts payable consists of amounts due to others for purchased goods and services. Bank notes payable typically includes the current portion of long term debt that you must pay within 1 year of the date on the balance sheet. Accrued expenses payable are such things as wages, interest, and taxes due that stand as a lien against the business.

The only *long term liability* in Illustration 1 is a mortgage of $25,000. If you include the current portion of this debt in bank notes payable (current liability), you should reduce the long term liability amount to reflect it. In general, long term liabilities are those that you expect to last more than 1 year. The total liabilities of My Business are $32,600 as of the balance sheet date.

Owner's equity in the business is listed as $28,578. This is the difference between total assets and total liabilities. Notice that the sum total of liabilities and owner's equity equals $61,178, the value of total assets.

For your balance sheet to be "in balance," *assets always must equal the sum of liabilities and owner's equity.* In other words, what your business owns must equal the sum of what you have invested.

Illustration 2 shows the balance sheet for My Business as of March 31, l9xx, one quarter later. All the current and long term account categories are the same as in Illustration 1. All the values are calculated in the same manner. That is important, because consistency in calculations from one period to the next is needed to measure change properly in your business over time.

By looking at the values of the balance sheet accounts from one time period to the next, you will be able to track the financial progress of your business. As an example, Illustration 2 shows a reconciliation of change in owner's equity.

The difference between owner's equity at the beginning and end of the period is $2,915. The source of that change is net profit generated during the period as shown on the profit and loss statement for My Business, which we will discuss later.

Another example balance sheet (this time, for Sales Galore) is shown in Illustration 3. One of the reasons for including this is to emphasize that there are a number of ways you can set up a balance sheet. Feel free to arrange it in any way you see fit, provided that it has a basic breakdown into assets, liabilities, and equity. Again, once you have decided on the format, *be consistent* from period to period.

In Illustration 3, assets as well as liabilities are broken down into current, intermediate, and long term. *Current categories* are still those that you expect to last no longer than I year.

Intermediate are typically those that you expect to last 2 to 10 years. Thus, *long term* is considered to be more than 10 years.

Note that intermediate and long term assets in this example are valued at current level, rather than on a cost less accumulated depreciation basis. That means that those values are estimates of current market value. For example, be sure to adjust accounts receivable for uncollectibles.

Profit and loss statement

This also is called an *operating statement* or an *income statement.* Its main purpose is to measure the earnings from your firm's business activity during the accounting period. It is a listing of the receipts and the expenses of the business.

The profit and loss statement tells you "how your business got to where it is. " Provided you prepare it using cost values, the profit and loss statement links your periodic balance sheets over time.

An example of a profit and loss statement for My Business is shown in Illustration 4, for the period January 1, l9xx, to March 31, 19xx. It shows *gross margin* first, which is the difference between *net sales* and *cost of goods sold.*

Assuming that you are selling goods that you buy from another source, cost of goods sold reflects the wholesale cost of the merchandise to you, including any service charge such as delivery. Net sales are total sales adjusted for customer returns and allowances.

Offsetting gross margin are two types of expense, variable and fixed.

Illustration 2

My Business
Balance sheet
March 31, 19xx

Assets			
Current			
Cash		$ 5,748	
Securities		2,345	
Accounts receivable		1,000	
Inventories			
Merchandise		13,000	
Supplies		3,300	
Total current assets			$25,393
Long term			
Equipment (at cost)	$ 7,000		
Less accumulated depreciation	– 1,300		
Equipment (net depreciated value)		5,700	
Buildings (at cost)	40,000		
Less accumulated depreciation	– 10,000		
Buildings (net depreciation value)		29,900	
Land (at cost)		1,800	
Total long term assets			37,400
Total assets			$62,793
Liabilities			
Current			
Accounts payable	$ 900		
Bank notes payable	4,900		
Accrued expenses payable	1,000		
Total current liabilities		6,800	
Long term			
Mortgage		24,500	
Total liabilities			$31,300
Owner's equity			31,493
Total liabilities and equity			$62,793
Reconciliation of change in owner's equity			
Owner's equity January 1, 19xx		$28,578	
Owner's equity March 31, 19xx		31,493	
Change in owner's equity			$ 2,915

Illustration 3

Sales Galore
Balance sheet
January 1, 19xx

Assets			
Current			
Cash in hand	$ 100		
Cash in bank	1,200		
Inventory	2,800		
Total current assets		$ 4,100	
Intermediate (market value)			
Machinery	$ 8,000		
Livestock	2,500		
Total intermediate assets		10,500	
Long term (market value)			
Buildings	$ 4,350		
Land	10,000		
Total long term assets		14,350	
Total assets			$28,950
Liabilities			
Current			
Current portion of noncurrent loans	$ 2,000		
Wages payable	1,000		
Supply bills	1,000		
Total current liabilities		4,000	
Intermediate			
Machinery debt	2,200		
Personal loan	5,000		
Total intermediate liabilities		$7,200	
Long term			
Real estate loan	8,000		
Total liabilities			$19,200
Net worth			9,750
Total net worth and liabilities			$28,950

Illustration 4

My Business
Profit and loss statement
for period January 1, 19xx, to March 31, 19xx

Sales, net		$16,979	
Cost of goods sold		– 6,196	
Gross margin			$10,783
Variable expenses			
Wages	$ 2,747		
Administrative	50		
Advertising	200		
Supplies	200		
Repairs and maintenance	30		
Other	—		
Total variable expenses	3,227		
Fixed expenses			
Taxes	$ 1,000		
Insurance	500		
Depreciation	585		
Accounting and legal	100		
Utilities	300		
Other	35		
Total fixed expenses	2,520		
Total operating expense			– 5,747
Net operating income (before interest)			5,036
Interest expense			– 750
Net income (before tax)			4,286
Taxes			– 1,371
Net income (after-tax cash basis)			$ 2,915

Variable expenses are those that are associated with the volume of business you are doing. If you are not doing any business, variable expense equals zero.

On the other hand, the *fixed expense* categories are those that exist regardless of whether you have any volume of business or not. Interest expense in this example is listed as a separate item following total operating expense.

Notice that the net income of $2,915 in Illustration 4 relates directly back to the reconciliation of net worth in Illustration 2. The profit and loss statement in Illustration 4 provides the link between the balance sheets for My Business in the first two illustrations.

The profit and loss statement for Sales Galore in Illustration 5 is another example of how you might design yours. *Operating receipts* are simply the cash sales for the period. No attempt is made to divide offsetting *operating expenses* into variable and fixed categories.

Rather than net income, the difference is return to operator labor, management, and capital because no specific costs for these items have been included in operating expenses.

Illustration 5

Sales Galore
Profit and loss statement
for period January 1, 19xx, to March 31, 19xx

Operating receipts		
Crops	$8,200	
Livestock	3,500	
Total operating receipts		$11,700
Operating expenses		
Livestock	$1,725	
Machine maintenance	1,015	
Crop seed and fertilizer	3,400	
Labor, hired	2,050	
Depreciation	1,200	
Property taxes	220	
Insurance	30	
Rent	450	
Utilities	100	
Interest	300	
Miscellaneous	60	
Total operating expenses		10,550
Return to operator labor, management, and capital (before-tax cash basis)		$ 1,150

Sources and uses of funds statement

This statement can be an important management tool for you. Prepare it at the same time you do your balance sheet. It shows how cash is generated in your business and how it is used. Simply put, it is a comparison between the dollar amount of each account on your balance sheet at the beginning and at the end of the accounting period.

A *source of funds* is defined as a decrease in the dollar amount of an asset account during the period or an increase in any liability or net worth account.

In contrast, a *use of funds* is defined as an increase in any asset account during the period or a decrease in any liability or net worth account. Sources must equal uses.

Keeping these definitions in mind, Illustration 6 may be helpful to show you the construction of a sources and uses of funds statement. It compares all the accounts for My Business between the January 1, l9xx, and March 31, l9xx, balance sheets.

Notice that each set of accounts balances properly—that is, total assets equal total claims on assets. Both total liabilities and owner's equity are included in total claims on assets.

The difference for each account is then calculated and the value indicated as a source or use of funds based on the definitions we described earlier. As an example, accounts receivable (an asset account) was reduced by $1,000 during the quarterly period. That released $1,000 to be used in other ways in the business (a source of funds).

The bank notes payable account (a liability) was reduced by $900 during that same time (a use of funds). Another way of looking at it is to say that $900 of funds in the business was used to reduce that current liability account.

Earnings generated in the business during that period increased owner's equity. These dollars became a source of funds for use in the business.

Illustration 6

My Business
Sources and uses of funds statement
January 1 versus March 31, 19xx

	January 1 19xx	March 1 19xx	Source	Use
Assets				
Cash	$ 2,748	$ 5,748		$ 3,000
Securities	2,345	2,345	—	—
Accounts receivable	2,000	1,000	$ 1,000	
Merchandise inventory	12,600	13,000		400
Supply inventory	3,500	3,300	200	
Equipment	7,000	7,000	—	—
Equipment depreciation	1,015	1,300	285	
Buildings	40,000	40,000	—	—
Building depreciation	9,800	10,100	300	
Land	1,800	1,800	—	—
Total assets	$61,178	$62,793		
Claims on assets				
Accounts payable	$ 1,000	$ 900		100
Bank notes payable	5,800	4,900		900
Accrued expenses payable	800	1,000	200	
Mortgage liability	25,000	24,500		500
Owner's equity	28,578	31,493	2,915	
Total claims on assets	$61,178	$62,793	$4,900	$4,900

During the quarter, $4,900 was generated in the business as a source of funds. It came from reduced accounts receivable and supply inventories, depreciation, increasing payables, and profits. Those funds were used to generate cash, increase merchandise inventory, and reduce current and long term liabilities.

Over time, analyzing sources and uses of funds statements for your business will help you track where funds are being generated and how well you're using them for growth and profit generation.

These statements also can be a good tool to help in planning future directions for your business, including identifying where funds are needed and possible internal or external sources for those funds.

The analysis and interpretation of balance sheet and income statements can help you. You can use them to determine the profitability of the business during specific time periods. You can project your future ability to service debt requirements as well as determine if expansion is possible.

From these statements, you can obtain information on trends in receipts, gross income, expenses, and returns in relation to past decisions. You can identify the causes of a strong or weak financial condition and of low or high profitability. You also can pinpoint changes that will make your business more profitable and improve its financial condition.

In addition, the statements can help you compare your firm's financial condition and profitability to the operating results of similar businesses.

If you're going to analyze these statements properly, they must be timely and accurate. As a manager, you need to know how well the resources of your business have been used to produce a return.

Cash flow analysis

Forecasting cash flow is an important part of good financial management. It involves the preparation of a cash flow budget to estimate future cash requirements necessary for your business operations. Cash flow budgeting involves forecasting all expected cash flow receipts and disbursements on a monthly, quarterly, or annual basis. It can help you to identify periods when there may be surplus cash and when to expect cash deficits.

A cash flow budget can be one of the most valuable financial planning tools available to you as a manager. It can help you make the most efficient use of cash. You also can determine any financing requirements for seasonal cash needs. Then you can develop a sound borrowing program.

Your cash flow budget can help determine when to make debt repayments and when you may have funds available for expansion purposes. Furthermore, a cash flow budget can help identify the availability of any surplus cash for investment in other profitable enterprises.

Another benefit from the preparation of a cash flow budget is that it allows you to review many aspects of your business that might otherwise be receiving inadequate attention or that you may have overlooked during your day-to-day activities.

Illustration 7 shows an example cash flow worksheet format for Sales Galore. It is called a "pro forma" statement, one that projects cash inflows and outflows by quarter for the remainder of the year l9xx.

Your own cash flow worksheet won't necessarily have only the categories shown in the example. You may need more or fewer, depending on the unique situation for your business. The object is to identify every flow of cash, regardless of its source or use.

In the example, line **20** is a minimum cash balance that you establish as an amount needed to handle contingencies. You as the manager-owner need to make a judgment about the level of reserve. Once you establish it, maintain that level.

A shortfall is expected for Sales Galore (as shown in line **21**) for the July l to September 30, l9xx, period. It is anticipated that a cash-over (excess cash) position greater than the shortfall will exist in the fourth quarter ending December 31, 19xx. Thus, Sales Galore is expected to end the year with a positive cash balance.

The business will use new short term borrowing to make up the third quarter deficit and maintain an acceptable cash balance (line **22**). The new short term debt plan calls for complete payoff in the last quarter (no carryover). At the bottom of the worksheet you design for your own use, you can project accumulated new short term and long term borrowings and track them for the year.

Illustration 7

Sales Galore
Quarterly cash flow worksheet
for the period April 1 to December 31, 19xx

	April 1 to June 30, 19xx	July l to Sept. 30, 19xx	October 1 to Dec. 31, 19xx	3-quarter total
Cash inflows				
1. Net cash sales	$3,000	0	$16,000	$19,000
2. Collection of acct. rec.	0	0	4,000	4,000
3. Capital sales	0	0	3,500	3,500
4. Other	0	0	700	700
5. Total cash inflows	3,000	0	24,200	27,200
Cash outflows				
6. Hired labor	1,600	3,500	3,000	8,100
7. Family labor	0	1,500	0	1,500
8. Supplies	1,000	500	0	1,500
9. Utilities	50	50	100	200
10. Insurance	30	30	30	90
11. Taxes, licenses, and fees	0	0	500	500
12. Capital expenditures	0	0	4,500	4,500
13. Loan principal due	0	0	8,680	8,680
14. Loan interest due	300	300	470	1,070
15. Other expenses	60	60	60	180
16. Total cash outflows	3,040	5,940	17,340	26,320
Cash balance				
17. Net cash from operations (**5–16**)	(40)	(5,940)	6,860	880
18. Beginning cash balance	1,300	1,260	1,000	1,300
19. Net cash available (**17 + 18**)	1,260	(4,680)	7,860	2,180
20. Minimum acceptable cash balance	1,000	1,000	1,000	1,000
21. Cash surplus (deficit) (**19–20**)	260	(5,680)	6,860	1,180
22. New short term borrowing for operating expenses necessary to maintain minimum cash balance	0	5,680	(5,680)	0
23. New long term borrowing for capital expenditures necessary to maintain minimum cash balance	0	0	0	0
24. Owner capital add. (withdrawals)	0	0	0	0
25. Ending cash balance (**19 + 22 + 23 + 24**)	1,260	1,000	2,180	2,180
Accumulated new borrowings for year				
Short term	0	5,680	0	0
Long term	0	0	0	0

Maintaining your financial health

As a manager, you can maintain a healthy capital structure by giving attention to four basic factors: liquidity, leverage, profitability, and asset usage.

Liquidity

This relates to your ability to pay bills on time, and it involves maintaining an adequate working capital position. Working capital is the amount by which current assets exceed current liabilities. It's essentially a financial cushion, and you can use it to take advantage of things like trade discounts and expansion opportunities.

Profits constitute a principal source of working capital. You also may use long term borrowings and the sale of fixed assets such as land, buildings, and equipment to increase working capital.

Naturally, it's not usually a good idea to increase your working capital through fixed asset sales. You shouldn't use long term borrowing, either, unless you expect your business to grow or the value of your assets to appreciate.

So, to maintain a good liquid position, focus your attention (at least at first) on making profits to provide adequate working capital.

Common measures of liquidity include a *working capital* calculation and *current ratio.* In the case of My Business for March 31, l9xx (Illustration 2), we determine the level of working capital by subtracting current liabilities from current assets:

$$\text{working capital} = 25{,}393 - 6{,}800 = 18{,}593$$

We determine the current ratio (another way of looking at working capital) by dividing current assets by current liabilities:

$$\text{current ratio} = \frac{25{,}393}{6{,}800} = 3.7$$

Remember that these values by themselves are not very meaningful. They become significant only when you compare them with other values for your business over time, or with average values for similar businesses. A value in one setting may be good, but in another setting it may be bad. This is true for any calculated value of this type.

Leverage

The mix of debt and equity capital you use in your business is called *leverage.* If the capital structure of your business is highly dependent on debt, you run the risk of being unable to meet the fixed interest charges associated with that debt if sales should fall off and cash flow not materialize as planned.

As the amount of debt increases relative to your equity capital investment in the business, the financial risk within your business tends to increase. If your business should incur a loss, you might be unable to meet its principal repayment obligations as well as the associated interest charges.

Typical measures of leverage include the debt-to-asset ratio and the debt-to-equity ratio. In the case of My Business for March 31, l9xx, the debt-to-asset ratio equals total liabilities divided by total assets:

$$\text{debt-to-asset ratio} = \frac{31{,}300}{62{,}793} = 0.50$$

To find the debt-to-equity ratio, divide total liabilities by total equity:

$$\text{debt-to-equity ratio} = \frac{31{,}300}{31{,}493} = 0.99$$

The debt-to-equity ratio measures the total debt of your business as a percent of the equity capital you have invested in your business.

Profitability

The profitability of your business refers to its net income return to total capital invested in the business (assets), equity capital invested in the business (net worth), and receipts (gross returns). These measures of profitability frequently are calculated as return on assets, return on equity, and return on sales.

For the My Business example in Illustrations 2 and 4, to calculate return on assets, divide the net income amount from the profit and loss statement (Illustration 4) by the total assets from the balance sheet (Illustration 2):

$$\text{return on assets} = \frac{2{,}915}{62{,}793} = 4.6\%$$

To find the return on equity, divide net income (Illustration 4) by owner's equity (Illustration 2):

$$\text{return on equity} = \frac{2{,}915}{31{,}493} = 9.3\%$$

The values that go into the return on sales calculation both come from the profit and loss statement. Divide net income by net sales:

$$\text{return on sales} = \frac{2{,}915}{16{,}979} = 17.2\%$$

You need to establish reasonable objectives for each of these three indicators of profitability. To help establish these objectives, consider at least four factors.

The interest rate on borrowed capital, the first factor, will impact the total capital you have invested in your business. It can lower net receipts due to interest payments made on the borrowed capital. You want returns on your assets to be greater than the interest rate for the borrowed funds used in your business.

The degree of risk associated with the possibility of a financial loss of the equity capital invested in your business is the second factor you should include in your analysis. Can you afford to lose your equity if your business has a high probability of failing? If not, a higher return to your equity may be necessary as a risk-taking reward to justify its use.

The rate of inflation is an important third factor. If the rate is high, it would require a higher dollar return to maintain real (purchasing power) returns. It also may influence your replacement decisions on depreciable fixed assets. As an example, the purchase price of new assets might be increasing also.

The opportunity cost of your equity is the final factor to consider. Opportunity cost is the return you could be earning from investment of your equity in the next best alternative.

Asset usage

Asset usage is another factor involved in maintaining a healthy capital structure. One indicator of asset usage in your business is *inventory turnover.* Another indicator of efficiency that you can use is *asset turnover* in your business (receipts ÷ total assets).

Yet another indicator of efficiency you might want to consider using is *working capital turnover* (receipts ÷ working capital).

You also should establish objectives for these indicators of business asset usage. It may help to show these common measures of efficiency, using the example balance sheet and profit and loss statement for My Business (Illustrations 2 and 4).

As in the case with the other categories of performance measurement, there are a number of additional ratios that you could calculate. How many depends on the situation for your business and the measurements you feel are useful. Here are three examples:

1. Inventory turnover:

$$\frac{\text{cost of merchandise sold}}{\text{merchandise inventory}} = \frac{6{,}196}{13{,}000} = 0.48$$

2. Asset turnover:

$$\frac{\text{net sales}}{\text{total assets}} = \frac{16{,}979}{62{,}793} = 0.27$$

3. Working capital turnover:

$$\frac{\text{net sales}}{\text{working capital}} = \frac{16{,}979}{18{,}593} = 0.91$$

The working capital value was calculated earlier as a measurement of liquidity (page 12).

Management control and planning

You can help keep the capital structure of your business healthy by doing a number of things. It is important to maintain the business in a liquid position so that you can meet debt obligations and pay bills on time.

You should maintain a reasonable and safe mix between debt and equity capital, to keep the business going in case an adverse situation should occur. You also need to determine adequate levels of return on total capital, equity, and receipts. Try to be as efficient as you can in using your business assets.

You as the manager must control the financial aspects of your operation if you are to achieve your financial objectives. For example, you must control each of the key performance areas (KPA's) you determined in your profit-planning process (page 2). In general, this involves keeping plans on target and on schedule—and taking corrective action or making adjustments when these are needed to ensure that your objectives are met.

More specifically, controlling involves the process of measuring actual results and comparing these to your planned results. Planned results are those that should have happened if events had occurred as you projected.

When actual results fail to meet planned results, corrective action may be needed to control the

process. This management technique can be summarized in these four steps:

1. Establish measurable planned results for each KPA.
2. Measure the actual KPA results.
3. Compare actual results to planned results.
4. Take action to correct deviations when actual results are not within your acceptable tolerance levels for each KPA.

You may want to operate by the principle of *management by exception* when you apply the control process. This requires that you set up an acceptable performance range for each KPA planned result. Actual results then may fluctuate within this range without the need to take corrective action.

Only when the actual results are out of this predetermined range would you take corrective action. In this way, you implement your management action plans and accomplish your objectives.

Preserving your capital investment is just as important as any other financial matter related to your business. Failure to take precautionary measures to preserve your investment could result in undesirable consequences.

The worst of these would be to go out of business (bankruptcy) or not to ensure beforehand a smooth transfer of the business to your heirs. There are a number of ways to preserve the capital investment in your business. These may include:

1. Maintaining adequate business and liability insurance coverage
2. Implementing an ongoing employee-management development training program to make better business decisions
3. Estate planning for transferring the business to other parties
4. Diversifying into other areas of operation, when appropriate, to spread business risk

Planning to obtain the capital you'll need to remodel existing facilities, acquire new facilities, replace equipment, or diversify into new areas of operation is an important aspect of financial management. In planning the capital needs of your business, you need to determine five things:

1. How much capital you'll need
2. When you'll need it
3. What type of financing to use (equity, short term debt, trade credit, long term debt)
4. The source where you can obtain it at the best terms
5. How, if necessary, you'll repay the funds (your cash flow budget will be helpful here)

In addition, when planning for your future capital needs involves the securing of debt capital, it's important not to become overly indebted, given your risk preference and profitability analysis—that is, not to borrow more than you require to effectively operate your business.

In part, this involves maintaining a good working relationship with the lenders who are providing the financing. It also involves accurately forecasting the cash flow requirements of your business.

For further reading

These books are only examples of good texts that provide more advanced information on financial concepts and tools. Other good texts and publications on this subject may be available from your local library or bookstore.

Altman, Edward, and Mary McKinney, eds., *Financial Handbook,* 5th ed. (New York: Wiley, 1981).

Archer, Stephen, and Charles D'Ambrosio, with collaboration of William Sharpe, *Business Finance: Theory and Management* (New York: Macmillan, 1966).

Beranek, William, *Working Capital Management* (Belmont, CA: Wadsworth, 1966).

Brandt, Louis, *Analysis for Financial Management* (Englewood Cliffs, NJ: Prentice Hall, 1972).

Brandt, Louis, *Business Finance: A Management Approach* (Englewood Cliffs, NJ: Prentice-Hall, 1965).

Brightly, Donald S., *Complete Guide to Financial Management for Small and Medium-Sized Companies* (Englewood Cliffs, NJ: Prentice-Hall, 1971).

Butters, J.K., W.E. Fruham, Jr., and T.R. Piper, eds., *Case Problems in Finance,* 9th ed. (Homewood, IL: R.D. Irwin, 1987).

Christy, G.A., and P.F. Roden, *Finance: Environment and Decisions,* 3rd ed. (San Francisco: Canfield Press, 1981).

Cohen, J.B., and S.M. Robbins, *The Financial Manager: Basic Aspects of Financial Administration* (New York: Harper and Row, 1966).

Financial Management Series, Nos. 89 to 115 (New York: American Management Association, 1948 to 1957).

Hastings, Paul G., *The Management of Business Finance* (Princeton, NJ: Van Nostrand, 1966).

Hunt, Pearson, C.W. Williams, and G. Donaldson, *Basic Business Finance,* 4th ed. (Homewood, IL: R.D. Irwin, 1971).

Johnson, Robert W., *Financial Management,* 5th ed. (Boston: Allyn and Bacon, 1982).

Jones, R.G., and Dean Dudley, *Essentials of Finance* (Englewood Cliffs, NJ: Prentice-Hall, 1978).

Neave, E.H., and J.C. Wiginton, *Financial Management: Theory and Strategies* (Englewood Cliffs, NJ: Prentice-Hall, 1981).

Shuckett, D.H., and E.J. Mack, *Decision Strategies in Financial Management* (New York: American Management Association, 1973).

Spiro, Herbert T., *Finance for the Nonfinancial Manager,* 2nd ed. (New York: Wiley, 1982).

Swick, Jack, *A Handbook for Small Business Finance,* Small Business Management Series No. 15, 7th ed. (Washington, DC: U.S. Small Business Administration, 1965).

Ordering instructions

If you would like additional copies of EC 1222, *Managing a New Business: A Beginner's Guide to Financial Concepts and Tools,* send $1.50 per copy to:

Publication Orders
Extension & Station Communications
Oregon State University
422 Kerr Administration
Corvallis, OR 97331-2119
Fax: 541-737-0817

We offer discounts on orders of 100 or more copies of a single title. Please call 541-737-2513 for price quotes.

World Wide Web

You can access our Educational Materials catalog and some of our publications through our Web page at *eesc.orst.edu*

This publication was prepared by Elizabeth Woodley, education project aide, and Larry Burt, Extension economist, Department of Agricultural and Resource Economics, Oregon State University.

This publication was produced and distributed in furtherance of the Acts of Congress of May 8 and June 30, 1914. Extension work is a cooperative program of Oregon State University, the U.S. Department of Agriculture, and Oregon counties.

Oregon State University Extension Service offers educational programs, activities, and materials—*without regard to race, color, religion, sex, sexual orientation, national origin, age, marital status, disability, and disabled veteran or Vietnam-era veteran status*—as required by Title VI of the Civil Rights Act of 1964, Title IX of the Education Amendments of 1972, and Section 504 of the Rehabilitation Act of 1973. Oregon State University Extension Service is an Equal Opportunity Employer.

Published May 1985. Reprinted April 1998.